Commentary
by Steve Henningsen
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What Do We Face?

'My father is Janus, the god of two faces. I am used to seeing through masks and deceptions."
— Rick Riordan, The Blood of Olympus

"I prefer to see myself as the Janus, the two-faced god who is half Pollyanna and half Cassandra, warning of the future and perhaps living too much in the past – a combination of both."
–Ray Bradbury, American author

Wikipedia defines the ancient Roman god Janus as "the god of beginnings, gates, transitions, time, doorways, passages, and endings. He is usually depicted as having two faces, since he looks to the future and to the past. It is conventionally thought that the month of January is named for Janus, but according to ancient Roman farmers' almanacs Juno was the tutelary deity of the month."

Janus can also be thought of as two-faced, as in hypocritical or deceitful. Either in his transitional or two-faced way, Janus has seemed to hover over our heads lately. Many wonder which President Trump will show up after the inauguration; the blustering, narcistic one that will tear up past treaties, impose border taxes and Tweet out whatever comes to mind or a more chilled, Presidential pondering Trump that will seek guidance from his advisors before Tweeting, I mean deciding, on difficult decisions. Has the true face of the news networks come to light as "fake news" stories permeate the media? Is the ongoing battle between inflation and deflation showing signs inflation is finally gaining the upper edge? Is it the U.S. dollar vs. all other currencies? Are democracy and globalism shifting inwardly as nationalism takes hold globally? Is the global economic malaise about to end as governments attempt to take the stimulus baton from the central banks? Will the ongoing economic power shift from West to East continue or will China's new Silk Road project, *One Belt, One Road*, hit a debt wall? While we may know, or think we know, what changes may lay ahead, what nobody knows is which way the face will turn.

Enter Reagan II?

"The end of democracy will occur when government falls into the hands of lending institutions and moneyed incorporations."
–Thomas Jefferson

Upon Trump's Presidential election win, some quickly began touting him as the next Reagan with similar views on tax cuts, deregulation and infrastructure spending. It was also quickly apparent that he was setting up a big-bank and corporate-friendly administration. (Trump's first 17 cabinet-level picks have more money than a third of American households combined.)

However, as shown by this chart, comparing the economic statistics between these two times is truly like staring into the two faces of Janus. Reagan faced tailwinds, while Trump headwinds. Reagan began with high interest rates, inflation, savings rates and low debt levels, and stock market multiples. Trump enters through an opposing door. Productivity growth is a fraction of Reagan's time, bond yields are at record lows, stock valuations are at near-record highs, and Uncle Sam's debt load is several multiples higher than the early '80s. Trump is receiving an economic machine with the vitality of a late stage Baby Boomer.

	1982	Today		1982	Today
Fed Funds Rate	18.00%	0.50%	Annual Inflation Rate (CPI)	8.00%	1.60%
10 Year Treasury Yield	15.00%	2.30%	Personal Savings Rate	10.00%	5.00%
Mortgage Rate	16.25%	3.87%	Labor Force Participation	64.00%	63.00%
Household Debt to Income	62.00%	130.00%	S&P 500 - CAPE10	7	26
U.S. Government Debt to GDP Ratio	30.00%	105.00%	S&P 500 - Median Price to Sales Ratio	.50x	2.20x
Total U.S. Debt to GDP Ratio	.90x	3.60x	Median Age Baby Boomers	26	60
Productivity Growth	2.00%	0.25%	Global Trade Barriers	Falling	Rising

Data Courtesy: St. Louis Federal Reserve (FRED), Bloomberg, Bureau of Economic Analysis

"The postelection Trump rally in the stock market is evidence of euphoric optimism about the fiscal stimulus, reduced regulations and lower taxes that are hoped for. And yet we mustn't forget where we are today, with distorted pricing in virtually all markets and extremely levered public and private balance sheets, all driven by monetary interventionism on a scale never seen before: By most measures, the stock market is as expensive as it has been for a century, save only the giddy late 1990s. We must also remember what got us to this spot: namely, extreme, collectivist interventionism by the heavy hand of the state. Perhaps never before have we had such a clear case of a controlled experiment in the effects of economic (and especially monetary) interventionism."
–Mark Spitznagel, founder and chief investment officer of Universa Investments 12/15/16

I'm in agreement with Mr. Spitznagel that there was a lot of hope injected into the financial markets going into the end of the year. It seemed as though many market participants were developing their premise that President Trump and a Republican Congress would pass pro-growth policies that will lead to higher profits and inflation. However, might it be more difficult for President Trump to push through all his changes. Since World War II there has been four cases when a Republican succeeded a Democratic president (Reagan was one of them.) Ironically, in each case the stock market fell in his first year of office. (Personally, if I were Trump getting a lemon of an economy, I would want it to fall apart the first year so that I could claim it was the previous administration's fault and then get to turn things around in time for the next election.)

Mr. Global, You're Fired!

"Once markets accept that Trump is not bluffing – that he really does intend to smash globalism – euphoria will give way to alarm. For now Wall Street remains drunk on wishful thinking. The longer the delusion lasts, the stronger the dollar, and the greater the trouble in Asia and Latin America."
– Ambrose Evans-Pritchard, Trump, Interest Rates and Chinese Panic: Why Euphoria Could Turn to a Credit Crunch in 2017

Trumps not even in office yet and he's already creating a "Twit-storm" with threatening Tweets regarding trade policies. He's already bashed Japan, China, and Mexico. Now I'm no economist, but should Trump continue with his protectionist policies, I'm guessing reduced trade will offset the potential benefits of tax breaks and looser regulations. Bullying may work on reality television shows, but it tends not to play well on the global stage of economics.

It's not just Trump, as nationalism seems to be gaining a global foothold as evidenced by Brexit and the Italians' vote against a new government. Furthermore, in 2017, Europe faces important elections in the Netherlands, Germany, and France. As economists will tell you, national income is shared between capital and labor, and for too long now capital has taken most of the spoils and left the crumbs for labor.

In my opinion, the frustration surrounding the stagnation in living standards and increased wealth disparity has led to this sea-change in politics worldwide. Germany faces a reversal of the Treaty of Versailles, when it was they who were economically squeezed by France and England. Now it is they who squeeze their southern EU partners, unable to generate the growth needed to overcome their debts. The financial stresses continue to build, and with it, the doubts over whether or not the European Union can remain intact.

We will have to wait to see if this pendulous swing away from globalization towards nationalism is a short-term phenomenon or a longer-term trend. History has shown that periods of increasing trade barriers and tariffs don't lead to good economic outcomes. After Trump's latest threat to China, the Communist Party's Global Times newspaper posted on 1/05/17 the following response: *"There are flowers around the gate of China's Ministry of Commerce, but there are also big sticks hidden inside the door -- they both await Americans."* I thought it a pretty pithy response.

"The art of progress is to preserve order among change, and to preserve change amid order."
–Alfred North Whitehead

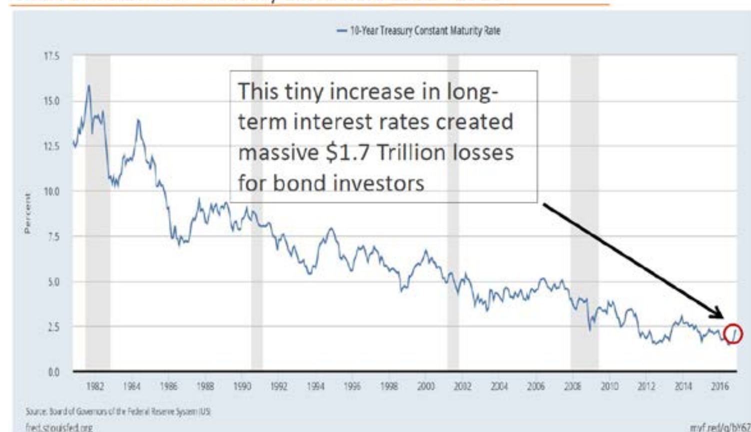
I wonder how Trump will handle China's and Russia's growing influence in world matters. Already Russia has brought back the Ukraine as a partner, become a driving force for change in the Syrian/ISIS conflict, while China continues broadening its trading routes via *One Belt, One Road* and wooing new economic partners such as the Philippines.

Let Bygones be Bygones.

"There have been 13 Fed rate hike cycles in the post WWII era, and 10 of these landed the economy in recession and the three that were aborted – the mid 1960's, the mid 1980's and the mid 1990's – were only aborted because the economy either slowed precipitously or there was a financial accident that forced the central bank to the sidelines. There has never been a Fed hiking cycle that ended benevolently."
–David Rosenberg, Chief Economist & Strategist Gluskin Sheff, 12/16

It isn't helpful to Trump that he chided The Fed's Janet Yellen during his campaign about her not raising short-term interest rates, accusing her of trying to help the Democrats. With the Fed raising rates in December and "claiming" that they will raise them again three or more times in 2017, Trump may regret his words. By raising short-term interest rates, the Fed is tightening the credit system in the economy. If it continues to raise them, then as Mr. Rosenberg states above, things tend to not end well for the economy. As shown in the graph, due to the highly-leveraged debt system, just the tiny backup in yields over the past few months has caused large bond losses.

Chart 1: US 10 Year Treasury Bond Yield 1982 - 2016



Another problem is the strong U.S. dollar and how it is choking foreign corporations that have borrowed trillions in dollars and struggle to pay it back as their locally denominated assets are depreciating. Countries like Mexico, Brazil, and Turkey are experiencing currency crises. If the dollar continues to strengthen, the pressure on foreign companies could reach a point of breaking. It is my supposition that another Plaza Accord type of meeting would have to be orchestrated to rework the monetary system away from the dollar. The question for highly-leveraged U.S. corporations is whether they feel the effects from

higher rates (interest costs) and a stronger dollar (decreased foreign revenues) before benefiting from lower taxes and regulatory burdens that Trump still needs to get through Congress. My guess is that Trump will hear a lot of whining from U.S. multinational firms at the beginning of the year as their overseas earnings diminish. Then, we might see him perform an about-face and start Tweeting sweet nothings to Janet Yellen in hopes of getting her to pull back on her interest-rate raising reins. Good luck with that.

Fake News

"You know well that government always kept a kind of standing army of news writers who, without any regard to truth or to what should be like truth, invented and put into the papers whatever might serve the ministers. This suffices with the mass of the people who have no means of distinguishing the false from the true paragraphs of a newspaper.

–Thomas Jefferson (letter to G.K. van Hogendorp, October 13, 1785

"Journalism is printing what someone else does not want printed: everything else is public relations."

–George Orwell

There was a lot written about Fake news last year so I'm not going to delve into it deeply. I feel it obvious that it has been with us since man began gossiping and rumor mongering eons ago. In my opinion, these days you can lump in the major news media outlets, as they are each so obviously biased that it is too painful for me to watch. The Brexit coverage and recent presidential election should have laid bare to the world how partisan these supposed "news" services are. Just watching the news correspondents "interview" their favorite Republican or Democratic politicians like fawning groupies was nauseating and, in my opinion, a sure sign of what Jefferson referred to as "serving the ministers." (I can barely remember a time when reporters would ask tough questions of their interviewees.) And does anyone really believe that Russia and Putin are behind everything that goes wrong in the United States? So, yes, there is a lot of propaganda on the internet these days, but also a lot of great information. Some of the most gifted writers and journalists have migrated to the internet in order to practice their craft more objectively. As I tell my kids, trust but verify and realize that we all have biases. You just need to consider the source before jumping to any conclusions.

Lastly, this supposed upswing in fake news goes hand in hand with what I perceive to be our fake financial markets. Central banks have destroyed free markets by distorting all asset prices via controlling short-term interest rates and buying up assets through their quantitative easing programs. Meanwhile, fake financial news channels –you know who you are– parade over the television like stock market cheerleaders, downplaying any potential market risks, while always at the ready to kneel before their central bank demigods for a quick, inconsequential soundbite. To rephrase *The Rime of the Ancient Mariner*, "Information, information everywhere, but hardly a word to believe."

Portfolio Ponderings

"…in the hands of politician's grand designs achieve nothing but new forms of the old misery…"

–George Smiley (Secret Agent): Tinker, Tailor, Soldier, Spy – John Le Carre

Janus showed his bi-face in the investment world last year, as the asset classes that performed well during the first half (mostly bonds and precious metals) quickly transitioned into some of the worst performers in the second half as the "Trump Bump" managed to get investors intoxicated with hopes of quickly passing pro-growth policies. Though Trump gets a fair amount of criticism, much of it deserved, I certainly wish him well in his task ahead. I think he will find it much more difficult getting things accomplished in Washington D.C. then in Trump Tower.

“When all the forecasters and experts agree, something else is going to happen.”
–Bob Farrell, market analyst

Going into the new year, Wall Street strategists seem to agree that the stock market will continue higher and the bond market will continue lower, driven by higher interest rates and an ever-higher dollar. I’m not so sure. As Mr. Farrell points out, when there is this much consensus, something different usually occurs. I’m guessing the *buy the rumor, sell the news* scenario manifests as we approach Trump’s inauguration, and maybe some of the Trump hopium starts to leak out of the balloon. I believe bonds and precious metals will bounce back at the beginning of the year, led by the realization that interest rates aren’t going to rise as quickly as some assumed.

Just one last kiss
Before I walk out the door
–J. Geils Band, One Last Kiss

While I’m confident that bonds will perform poorly in the years to come and there will come a time to sell them, or at least shorten their duration, I still believe yields have one more move lower, as a recession or a credit-driven event overseas would quickly chase investors back into the arms of U.S. Treasury bonds. While gold may continue to struggle against the headwinds of a rising dollar, both it and silver managed to post gains last year for the first time in three years. The case for maintaining our positions in precious metals remains intact. With growing stresses in the foreign currency markets, along with my belief that the dollar won’t be allowed to go much higher, the road ahead, although volatile, remains bright for them. In the equity world, the emerging markets have struggled these past few years, but presently represent the best value. Although we currently have no exposure to them, there will come a time, most likely when it’s clear that the dollar’s uptrend is over, to reallocate to this asset class.

I am closing this commentary with some snippets from an article I read recently by Eric Cinnamond. Eric has been an investment advisor for over 20 years and we share many of the same views regarding our industry. This article, Loyalty, Prudence, and Care hit close to home with me as I have expressed many of the same concerns to clients over the past few years.

“In all of my years of studying investing, I do not remember a class or book discussing how to account for central banks buying “unlimited” amounts of assets and “shielding” investors from risk. Do investment courses and books need to be rewritten? I continue to believe central bank policies will be deemed counterproductive and investing, along with free markets, will return. But what if investing and free markets don’t return? What if investors and markets allow central bank balance sheets grow to $10 trillion, $20 trillion, and beyond?

Considering central bank words and actions are currently the main drivers of asset prices, maybe it’s time higher education and the CFA Institute consider altering their curriculum to include guidance on how to invest in financial markets dominated by central banks. In addition to new rules and courses on investing, should code of ethics also be revised for the new world of central bank law and order?

…In my opinion, the current market cycle and its extreme level and broadness of overvaluation has made it challenging to comply with ethical standards related to prudence and reasonable care. Asset inflation has infected every asset class in one way or another. While bond yields have risen recently, they remain near record lows and, in my opinion, do not adequately compensate investors for risk assumed. Depending on your preferred valuation measure, stocks are also trading near or above record highs, especially on a median basis. On average, prices and valuations of my opportunity set (2.1x sales and 32x earnings) are unjustifiable when using realistic valuation assumptions…

…It’s highly unlikely that the creators of ethical standards envisioned the current investment environment – when central banks inflate almost all asset prices to imprudent levels. In effect, how can participants in the investment management industry act prudently and with reasonable care when asset inflation is so broad based? And how are

portfolio managers expected to act responsibly when policy makers are encouraging them to act irresponsibly? Does anyone really believe central banks want bond managers to sell their long bonds because they're not getting adequately paid? Absolutely not. Just look at recent encouraging "we've got your back" statements and actions by the ECB and BOJ. Or what about equity managers crowding into the most popular and most overvalued stocks? Do you think central banks want these managers to sell and create financial instability? Absolutely not. Central banks want and need asset inflation – they've been clear about the benefits of higher prices and how they will respond to protect economies from financial instability.

Is it time to revise code of ethics to take into consideration periods of unjustifiable asset prices and relentless central bank intervention? It's an interesting (and possibly uncomfortable) subject. How do ethical standards and concepts like fiduciary duty coexist in a world with rotating asset bubbles and extensive asset inflation?"

How indeed! As we transition into the new year, let's hope President Trump (and all our world leaders for that matter) has not only Janus looking down upon us, but Minerva as well; goddess of wisdom and sponsor of arts, trade, and strategy.

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